Paragraph 11.16 of the Consultative Document refers to "*discounts requiring careful vetting to ensure that they would not have some anti-competitive effect*", a time-consuming piece of "micro-market" regulation which is not the solution to anti-competitive practices. The only way to achieve retail pricing flexibility, while avoiding unfair competitive practices, is through enacting robust competition policy legislation.

Incremental costs should then serve as the floor for retail pricing. Of course the incremental costs for retail service are different to those for interconnection. One of the aims of the LRIC process is to strip away allocated costs which do not relate to the provision of interconnection. However such costs *must* apply to retail as they are incurred to attract, service or add-value to customers.

Thus, the LRIC for interconnection only includes those costs, including a rate of return on capital employed, necessarily incurred to provide interconnection, while the LRIC for retail includes all of the other aspects of the company's activities, from billing through to corporate donations.

Service providers

Question A in Chapter 13 asks why the USA enjoys a wider range of telecommunications services and service providers than the UK. The answer, we believe, is that the structure of telecommunications service - local loop service providers charging for local calls on a non-usage sensitive basis - has given an enormous boost to the provision of value added services. These services do not need to generate enough additional value to cover the cost of the call. Because of the different structure of the telecommunications sector in the UK, with local loop competition already in place, it is impossible to replicate these conditions exactly through regulation. Indeed, as competition develops in the US, the relationship between "toll" and "toll-free" services is also likely to change.

The interesting question for the UK is why the prospect of generating tremendous volumes of additional traffic through value-added services has not stimulated a plethora of innovative incremental cost-based tariff offers from telephone companies eager to stimulate growth and raise extra revenues. In the case of the new entrants, it is easy enough to identify the answer; BT retail price-based interconnection tariffs and the BT price cap serve to stifle innovation.

In the case of BT itself, the answer is less clear. We believe that it would clearly be in BT's commercial interests to seek to grow the market by encouraging as many distribution channels for its service as possible, with prices tailored to each channel. Indeed new entrants are attempting to do this within the constraints of the interconnection regime and price caps; Mercury One-2-One's free off-peak calls being perhaps the most well-known example.

As we believe that BT is not acting in its own best interests, it is difficult to determine what regulatory action, if any, should be undertaken to "force it to be free" from the monopoly mindset which still seems to dominate. New entrants need to struggle to acquire each and every customer. BT, with its massive installed base, market dominance and high brand recognition, need merely wait for the customer to call. Unfortunately, this strategy sub-optimises the distribution of "plain old telephone service", not least because it restricts potential service providers and users' choice of innovative new services.

It is clearly important to avoid creating regulatory distortions through forcing the company to provide service packages to large users or value added service providers which are not economically efficient. And, of course, competition will in due course solve the problem.

The example of cellular service provision

The spectacular success of the cellular service providers in achieving high *penetration* should not be confused with the creation of *competition*. The relationship between the cellular duopolists and their service providers is more like that of a franchiser and franchisee than between independent retailers and the suppliers of goods or services. While the service providers compete aggressively over the initial "sign-on" prices for mobile phones - and the innovation they have shown here is largely responsible for the way that mobile-phones have swiftly rolled down the demand curve - there is virtually no competition over tariffs. Because they simply receive a discount on the retail price, each service provider charges the same rate for each tariff package. Nor has there been much competition over service levels - although this is changing as some service providers are beginning to offer a broader service, catering for all their customers telecommunications needs.

Other comments relating to service providers

Question (c) seeks views on the licensing of service providers. We believe that the current regime is too complicated, and that there should be two classes of licensee; PTOs (who provide physical access to the network) and Telecommunications Service Licences (TSL).

Questions (d), (e) and (f) address complicated technical issues relating to intelligent networks. U S WEST has participated in discussions with the FCC in the US concerning their regulation, and we would like to be part of a similar process in the UK. We believe that this consultation should be conducted separately from the other issues raised in the Consultative Document.

Question (g) relates to access to numbering. We believe that numbers should be allocated equitably to organisations according to the purpose to which they will be put, rather than the nature of the company requesting the number. Thus all PTO's, when requesting numbers in their capacity as a PTO, should be treated equally. However if a PTO wishes to provide a service - such as a calling card - that company should not be treated any differently to any other company, whether a large user, a service provider or another licensed operator, which wants to offer a similar service.

Alternatives to pence per minute charging for interconnection services

We believe that it is likely that the "bottom-up" calculation of LRIC will establish that most, if not all, cost drivers in interconnection are not per-minute of usage based. The public policy imperative is that these costs, *whatever their structure*, are used as the interconnection tariff. They should not disadvantage any economically efficient competitor.

If an operator wishes to purchase a service on another basis - such as pence per minute - which does not reflect the LRIC of interconnection then that is a commercial matter for negotiation by that operator. The only interconnection tariff which should be made available is that which accurately reflects the cost drivers of the service. Where there is sufficient competition, and an equitable interconnection regime, BT's retail pricing structure, subject to competition and fair trading constraints, should be a matter for BT.

Conclusion

U S WEST welcomes the opportunity to comment on what we believe is the most significant regulatory review paper published by OFTEL. To summarise our comments, we believe that OFTEL should distinguish between two types of telecommunications service; interconnection and retail.

"Interconnection" should be tightly defined as those service components essential to call completion. The tariff for interconnection should be calculated through a "bottom up" approach which identifies the cost drivers and their long run incremental cost (LRIC), including the appropriate contribution to the cost of capital. There should be no arbitrary mark-up to this LRIC, as any attempt to add common or overhead costs will distort the market, serve as a barrier to effective competition and operate against the public good of "any to any" calling.

"Retail" covers all the other services which operators provide in the marketplace. Operators should recover all of their overhead costs from these retail services. Competition will force operators to allocate these costs to services in the most efficient manner.

In general, operators should have the freedom to tailor their prices to the market, subject to competition and fair trading rules. However there may be a short-term need, as competition develops, for regulatory action to prevent dominant operators exploiting their market power in parts of the market which are nominally competitive but which are, in practice, dominated by one or two operators.

Appendix

Detailed comment on the proposed mark-ups to LRIC

The Efficient Component Pricing Rule (ECPR)

The ECPR depends on a number of assumptions about the market-place which, in the case of telecommunications, are clearly not valid:

- perfectly substitutable, homogeneous products;
- competition only through price;
- a single technology used by all service providers;
- efficiently costed operations by the incumbent;
- incumbent prices equal to social marginal costs, based on the best available technology.

If these assumptions *were* to hold, then there would be no basis for competitive entry since society's resources would be already used to maximum efficiency and social welfare could not be improved by competition.

We agree with the criticisms of ECPR made by OFTEL in paragraphs 4.23-4.25. It is effectively a tool to protect incumbent monopolists.

Ramsey pricing and the inverse elasticity rule

When unable, because of natural monopoly, to adopt the best pricing rule of marginal costs, the "second best" approach is to seek to use that set of prices which will cause the least economic distortion, measured in terms of how those prices will change the pattern of consumption.

The solution to this "second best" approach proposed by Ramsey is known as the "inverse elasticity rule". This approach segments customers into groups according to their elasticity of demand, that is to say from those who are most price sensitive - any increase in price will stop them using the product all together - whose demand is perfectly elastic, through to those who are the most price insensitive - a price increase will have no impact on the amount that they consume - whose demand is perfectly inelastic. The more inelastic the demand, the higher the price charged.

This approach ensures that total consumption remains as close as possible to the level that it would have had the price equalled marginal cost for all customers, with this being sufficient for the firm to break-even.

However there are two policy problems to this approach:

- by setting the highest prices for the most inelastic customers, the heaviest burden is being placed on those who depend upon the product most. This may have undesirable social policy consequences;

- more importantly, it is impossible to segment classes of customer in a partly competitive market. Demand naturally becomes more elastic when there are competing alternatives. The Ramsey rule would suggest shifting prices from areas which are competitive to areas which are still monopoly provided - an anti-competitive move which allows the operator to cross-subsidise competitive markets from un-competitive markets. Customers object, as do other operators who, typically, have no monopoly of their own to exploit.

  Furthermore, in a partly competitive market, the incumbent no longer faces the market demand curve with its set of elasticities. It must instead take elasticities from its own demand curve which will differ from that of the market as a whole, thus creating a different set of cross-subsidised prices from the social-optimal set derived by Ramsey pricing in a monopoly.

In short, Ramsey pricing rules, while perhaps appropriate in a pure monopoly environment, are wholly inappropriate in a market moving towards full competition.

Equal Mark-ups

This approach to increasing LRIC is purely arbitrary. It has the benefit of administrative ease but, because of the random impact it will have on pricing signals, probably maximises the distortions, in terms of self-provision vs purchase decisions, over interconnection.

Market-based Mark-ups

In the United States, many states which practice rate-of-return regulation give the incumbent telephone company the right to recover the "revenue requirement" which is the product of the rate-of-return calculation. [3] Many states have also historically used the revenues earned from interconnection rates to contribute to the regulated revenue requirement so that less revenue needed to be recovered from residential rates.

Although the UK has explicitly rejected the notion of rate-of-return regulation, because it has poor efficiency incentives and encourages operators to "gold-plate" their investment programme, for the sake of completeness this section describes how U S WEST has approached this regime.

In the US, U S WEST has proposed that the principle of "essential facilities" should govern interconnection tariffs. Those elements defined by US anti-trust law as essential facilities for interconnection are charged on the basis of LRIC; other interconnection elements, which are available from other service providers or which can be reasonably self-provided, are charged at the market price. U S WEST in the United States has recognised that setting prices based on fully distributed costing methods creates pricing signals that distort both entry decisions and consumption decisions. While the elimination of these practices cannot occur overnight, their presence is antithetical to the development of a competitive telecommunications marketplace.

[3] Bell operating companies have been prohibited from providing many retail services such as interlata toll, cellular, video programming and have thereby been focused on providing wholesale capabilities to other providers.

A 25% ADDRESSABILITY STANDARD
DOES NOT SIGNIFICANTLY LIMIT A
LEC'S ABILITY TO INCREASE PRICES

Assume 25% Addressability/0% Competitive Share

	Competitive Area	Non-Competitive Area
LEC Share	25%	75%
Competitor Share	0%	0%

Case 1: LEC Introduces 10% Price Increase with 10% Share Loss in Competitive Area

	Competitive Area	Non-Competitive Area
LEC Share	22.5%	75%
Competitor Share	2.5%	0%

Economic Impact

Increased Revenues		Decreased Revenues
2.25%	Competitive Area	2.50%
7.50%	Non-Competitive Area	0.00%
9.75%		2.50%

Net Economic Gain - 7.25%

Case 2: LEC Introduces 10% Price Increase with 30% Share Loss in Competitive Area

	Competitive Area	Non-Competitive Area
LEC Share	17.50%	75%
Competitor Share	7.50%	0%

Economic Impact

Increased Revenues		Decreased Revenues
1.75%	Competitive Area	7.50%
7.50%	Non-Competitive Area	0.00%
9.25%		7.50%

Net Economic Gain - 1.75%

IMPACT OF 1% UPPER SERVICE BAND LIMIT ON LEC PRICING FLEXIBILITY

	+5% -10% SBI Limits	**+1% -100% SBI Limits**	**+2% -10% SBI Limits Tandem-Switched**	**+0% -100% SBI Limits RIC**
	(A)	(B)	(C)	(D)
Year 1				
PCI(t-1)	100.00	100.00	100.00	100.00
PCI Change	-2.00%	-2.00%	-2.00%	-2.00%
PCI(t)	98.00	98.00	98.00	98.00
<u>Service Band 1</u>				
Existing Revenue	$1,000,000	$1,000,000	$1,000,000	$1,000,000
SBI(t-1)	100.00	100.00	100.00	100.00
Price Change	-10.00%	-12.00%	-12.00%	-12.00%
Proposed Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t)	90.00	88.00	88.00	88.00
Upper limit	102.90	98.98	99.96	98.00
Lower limit	88.20	N/A	88.20	N/A
Year 2				
PCI(t-1)	98.00	98.00	98.00	98.00
PCI Change	-3.00%	-3.00%	-3.00%	-3.00%
PCI(t)	95.06	95.06	95.06	95.06
<u>Service Band 1</u>				
Existing Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t-1)	90.00	88.00	88.00	88.00
Price Change	0.00%	0.00%	0.00%	0.00%
Proposed Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t)	90.00	88.00	88.00	88.00
Upper limit	91.67	86.21	87.07	85.36
Lower limit	78.57	N/A	76.82	N/A
Mandatory Reduction	0.00%	-2.03%	-1.06%	-3.00%

IMPACT OF 1% UPPER SERVICE BAND LIMIT ON LEC PRICING FLEXIBILITY

	+5% -10% SBI Limits	+1% -100% SBI Limits	+2% -10% SBI Limits Tandem-Switched	+0% -100% SBI Limits RIC
	(A)	(B)	(C)	(D)
Year 1				
PCI(t-1)	100.00	100.00	100.00	100.00
PCI Change	-2.00%	-2.00%	-2.00%	-2.00%
PCI(t)	98.00	98.00	98.00	98.00
Service Band 1				
Existing Revenue	$1,000,000	$1,000,000	$1,000,000	$1,000,000
SBI(t-1)	100.00	100.00	100.00	100.00
Price Change	-10.00%	-12.00%	-12.00%	-12.00%
Proposed Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t)	90.00	88.00	88.00	88.00
Upper limit	102.90	98.98	99.96	98.00
Lower limit	88.20	N/A	88.20	N/A
Year 2				
PCI(t-1)	98.00	98.00	98.00	98.00
PCI Change	-6.00%	-6.00%	-6.00%	-6.00%
PCI(t)	92.12	92.12	92.12	92.12
Service Band 1				
Existing Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t-1)	90.00	88.00	88.00	88.00
Price Change	0.00%	0.00%	0.00%	0.00%
Proposed Revenue	$900,000	$880,000	$880,000	$880,000
SBI(t)	90.00	88.00	88.00	88.00
Upper limit	88.83	83.55	84.37	82.72
Lower limit	76.14	N/A	74.45	N/A
Mandatory Reduction	-1.30%	-5.06%	-4.12%	-6.00%

CERTIFICATE OF SERVICE

I, Diane Danyo, do hereby certify that on this 6th day of February, 1996, a copy of the foregoing "Reply Comments of AT&T Corp." was mailed by U.S. first class mail, postage prepaid, to the parties on the attached Service List.

/s/ Diane Danyo
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